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Redressing America's Public Infrastructure Deficit

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Chairman, Oberstar, Representative Mica, and Members of the Committee, thank you for inviting me to testify today on the question of "financing infrastructure investments."

Over the past several decades, we have accumulated a sizeable public infrastructure deficit. As a result, a variety of infrastructure bottlenecks—traffic congested roads, clogged ports, and an antiquated air traffic system, to mention just a few—have begun to undercut our economy's efficiency and undermine our quality of life.

One of the reasons for this infrastructure deficit is that our system for financing infrastructure has become increasingly inadequate with the passage of time and has not kept up with the practices of other advanced industrialized economies. That is why I am generally supportive of the various legislative proposals this Committee is now studying—in particular, the National Infrastructure Bank Act of 2007 (S. 1926 and H.R. 1301), introduced by Senators Christopher Dodd and Chuck Hagel in the Senate and Representatives Keith Ellison and Barney Frank in the House, and the National Infrastructure Development Act of 2007 (H.R. 3896), introduced by Representative Rosa DeLauro, which would establish a National Infrastructure Development Corporation and its subsidiary, the National Infrastructure Insurance Corporation, as wholly owned government entities. It is also why I favor the establishment of a federal capital budget, as I explain later.

The way we currently fund infrastructure in this country is flawed. At the federal level, infrastructure is funded largely out of general revenues and the highway trust funds. Thus, it is not surprising that in recent years political concerns over the budget deficit together with competing short-term spending needs have crowded out public infrastructure projects.

At the state and local level, the great majority of infrastructure is funded through the municipal bond market as well as through state and local budgets. But over the past decade or two, increased federal mandates for social spending, balanced-budget requirements, debt limitations, and increased competition among states to keep taxes low have restrained state and local borrowing as well as spending. The current economic slowdown and turmoil in the housing and credit markets threaten to further constrain state and local infrastructure spending. Because states and municipalities rely heavily on property and sales taxes, the housing correction and consumer slowdown are creating a budgetary crisis for many state and local governments. As of January of this year, 24 states were either facing a shortfall for FY 2009 or were expecting budgetary problems in the next year or two. The expected shortfalls are likely to accelerate as home foreclosures increase, property values decline, and consumer spending falls. New capital projects will be one of the first victims of this budgetary crisis.

Thus, our nation's infrastructure deficit will actually get worse unless we change the way we finance infrastructure investment. The major impediment to closing the infrastructure deficit is not a lack of available capital or high interest rates. Notwithstanding recent credit problems and bank liquidity concerns, the world is still awash in capital and long-term interest rates remain near historical low levels. In fact, there is no shortage of privately held funds to help pay for infrastructure reconstruction and development if it is undertaken in a market-sensitive manner. As Transportation Secretary Mark Peters recently noted, "there is upwards of $400 billion available in the private sector right now for infrastructure investment." Likewise, even with today's bank credit and liquidity problems, there are literally trillions of dollars available for high-quality debt investments through both domestic and international markets. The amount of funds held by central banks, sovereign funds, and global pension funds is estimated to be approaching $30 trillion—and growing fast. U.S. public pension funds alone have more than $3 trillion in assets; moreover, they have a long-term investment outlook that is consistent with the stable returns that infrastructure assets generate.

I would like to offer three recommendations for how we can take advantage of these large pools of capital—in the short term by more imaginatively using our existing capacity to borrow and over the slightly longer term by improving our system for financing infrastructure investment by pursuing the legislation proposed by Senators Dodd and Hagel and Congressmen Ellison and Frank and by Congresswoman Rosa DeLauro.

1. Make a Large Down Payment on our Infrastructure Deficit as Part of a New Economic Recovery Program.

My first recommendation is for the federal government to make a significant down payment on the public infrastructure deficit as part of new economic recovery program. The stimulus package passed by Congress earlier this year was too focused on providing a short-term boost to consumption, and will be too small and too transitory to create a sustainable recovery given the size of the housing and credit bubble, and the role that the housing played in sustaining consumption levels over the past decade. A second stimulus program will be needed that is longer in duration and that is more focused on investment and creating new jobs.

By making public infrastructure spending the centerpiece of a new economic recovery program, we would be able to accomplish several urgent public policy goals simultaneously. We would close the public infrastructure investment gap at a time of low borrowing costs; we would provide the economy a significant boost in investment and job creation that it is needed to put the economy on a new growth path that is less dependent on housing and debt-financed consumption; and we would make the economy more productive and efficient over the longer term by eliminating costly bottlenecks and by crowding in new private investment.

Public spending on infrastructure is the most effective way to counter an economic slowdown caused by the unwinding of a major asset bubble. And funding public infrastructure by issuing long-term Treasury Bills is still the lowest cost way to finance much needed public infrastructure improvements. For these reasons, we should use the necessity of a second stimulus package to close the public infrastructure deficit by dramatically increasing public infrastructure spending over the next two years. And we can do so without an equivalent increase in the budget deficit, since the deficit would widen in any case as tax revenues decline because of falling incomes for businesses and individuals and since public infrastructure spending would create new jobs and economic activity and thus increase tax revenues.

In comparison to other stimulus measures, such as cutting taxes, public infrastructure investment would have the advantage of directly creating more jobs, particularly more good jobs, and thus would help counter the negative employment effects of a collapsing housing bubble. For example, the U.S. Department of Transportation estimates that for every $1 billion in federal highway investment, 47,500 jobs would be created. Similarly, a recent California analysis concludes that each $1 billion of transit system improvements, including roadways, would produce 18,000 direct new jobs and nearly the same level of induced indirect investment.

Public infrastructure investment not only creates jobs but generates a healthy multiplier effect throughout the economy by creating demand for materials and services. The U.S. Department of Transportation estimates that for every $1 billion in federal highway investment more than $6.2 billion in economic activity would be generated. By comparison, tax cuts and tax rebates are estimated to produce only 67 cents in demand for every dollar of lower taxes. In short, public spending on infrastructure is the best way to provide long-term stimulus to the economy at the lowest cost and at the same time make it more productive and efficient.

Contrary to conventional wisdom, a public infrastructure program can be implemented in a sufficiently timely way to help counter an economic slowdown, in addition to providing long-term benefits for the economy. There are a number of ways to accelerate projects already planned and to provide federal guarantees and financing for state and local governments to speed-up spending on long-delayed public infrastructure improvements.

2) Establish a National Infrastructure Bank and Supporting Regulation.

My second recommendation relates to the proposed new programs for federal support of non-federal infrastructure investment. If properly designed, they would significantly improve our system for financing infrastructure investment.

State and local governments account for the lion's share of our nation's public infrastructure spending. For many years, the U.S. municipal bond markets have functioned well, allowing state and local governments to finance much of their infrastructure needs through the debt markets. But as noted earlier, state and local governments are experiencing new borrowing constraints as some states and localities bump up against debt ceilings or face increased borrowing costs because of deteriorating credit ratings and conditions. Moreover, our current financing structures do not allow states and localities to take advantage of the large institutional pools of capital, such as U.S. and European pension funds, that are available for infrastructure financing.

For these reasons, the federal government will need to do more in the future to bear the cost of infrastructure investment and to assist state and local governments with the financing of their infrastructure needs. It can do so by offering federal guarantees to help keep borrowing costs for state and local governments low and by creating new institutions to help state and local governments borrow more efficiently and to tap large pools of capital. In these respects, the proposed National Infrastructure Bank (NIB) and the proposed National Infrastructure Corporation (NIDC) move us in the right direction and would help modernize the way we finance infrastructure.

First, the proposed NIB and NIDC would give us the capacity at the federal level to issue long-term general-purpose and specific-project infrastructure bonds enabling us to tap more easily the private capital markets for financing public infrastructure. The bonds could be as long as 30 to 50 years in maturity, thereby providing an attractive financing vehicle for infrastructure improvements that have a useful life of several decades.

Second, the proposed NIB and NIDC would lower the borrowing costs for state and local governments by offering federal guarantees for state and local projects as well as by providing direct grants and start-up financing. A federal guarantee for state and local projects would lower the interest rates state and local governments need to pay in the municipal bond market by 50 to 100 basis points, saving state and local taxpayers millions of dollars each year.

Third, the NIB and NIDC would help remove politics from the funding equation, thus eliminating the standard political objections to public infrastructure projects as just "pork-barrel" politics. They would do so by providing a professional, non-partisan justification for needed infrastructure spending. The NIB, for example, would have a five-member independent board that would be appointed by the president and confirmed by the Senate. It would also have a professional staff to carry out a thorough review of projects based on return on investment and their contribution to the public good.

In these ways, the proposals for the establishment of a NIB or a NIDC would considerably improve our system of financing public infrastructure. But in other ways, the proposals do not go far enough to enable state and local governments to tap the large pools of institutional capital I mentioned earlier. In particular, there are two shortcomings in the proposed entities as they are now envisioned—for which I have two recommendations.

The first limitation relates to the question of capitalization. The Dodd-Hagel and Ellison-Frank bills would establish an initial $60 billion ceiling on the mount of the aggregate outstanding obligations the NIB can assume, which is low relative both to our infrastructure financing needs and the market's potential appetite for infrastructure investment. Moreover, the NIB, as currently envisioned, would not in fact operate like a bank but rather more like an agency with no capitalization, thus limiting its ability to create leverage the way infrastructure development banks in other countries do. The House proposal for a National Infrastructure Development Corporation (NIDC) would have the advantage of operating more like a bank in that it would be capitalized and would be able to use leverage to make loans and to issue and sell debt securities. But its initial capitalization of $3 billion in the first year (with a ceiling of $9 billion over three years) is too limited to address the scale of the nation's infrastructure needs.

My first recommendation, then, is to suggest that the Congress properly capitalize any national infrastructure financing entity it approves so that it can leverage its capital like most development banks do. Again, take the case of the proposed NIB. If it were properly capitalized and operated more like a bank, the NIB would be able to make loans and loan guarantees some five times its initial capitalization. Thus, it would be able to finance $300 billion in new infrastructure projects as opposed to merely $60 billion, greatly expanding the amount of financing available for infrastructure investment. Even the very conservative European Investment Bank allows for leverage of two and half times it capital.

Second, the NIB and NIDC, as now conceived, would do little to help state and local governments attract larger institutional financing, because they do not explicitly allow for the pooling of privately created infrastructure-backed loans. The problem that state and local governments now face is that any one bond issuance is in most cases just too small to attract institutional interest. Large institutional funds and central bank managers prefer to focus on bond issues in the range of $500 million and above, with many preferring bond issue above $1 billion. In addition, large institutional investors are not attracted to municipal bonds because they do not generally benefit from their tax-exempt status. For these reasons, they do not participate in the municipal bond market in any active way. The issuance size and lack of liquidity of the municipal bond market therefore limits the range of investors and drives up the cost of issuing bonds. To overcome this problem, an infrastructure bank should have the authority to bundle various state and local bonds, and to offer the larger bundled instruments to large institutional investors much like Fannie Mae and Freddie Mac do.

My second recommendation, therefore is that any new government agency or bank not only be properly capitalized but that it have the explicit authority to pool, package, and sell existing and future public infrastructure securities in the capital markets. Such an entity should also have the in-house capability to originate infrastructure loans and thus the ability to fund itself through the international capital markets. With this authority and this capability, a NIB or NIDC would be able to channel private finance into public infrastructure almost immediately. As importantly, they would be able to tap financing from large institutional investors—from large U.S. and European pension funds, insurance companies, central banks, sovereign wealth funds, and other institutional investors. Thus, they would allow us to raise more capital for public infrastructure investment more efficiently and at a lower cost than we can do through the municipal bond market as it now exists.

3) Establish a Federal Capital Budget.

My final recommendation is for the government to move as quickly as is feasible to capital budgeting, which is needed to help us establish better spending priorities and develop a more sensible approach to fiscal responsibility. As is well known, a capital budget would separate in a transparent way long-term capital expenditures (for which borrowing is appropriate) from current operating expenses (which normally should be covered by tax revenues). It would thus not only make our government more accountable for its spending priorities. But as importantly, it would give us the latitude to finance big public infrastructure investment projects when needed without the constraints of fitting expenditures in any one budget year.

For this reason, the establishment of a federal capital budget is a necessary complement to the creation of a national infrastructure bank or financing entity. Current federal budget principles treat public infrastructure investment as if it were an ordinary operating expense. Expenditures on public infrastructure thus show up in the budget in the year they are expended even though the infrastructure may have a useful life of several decades. In requiring upfront recognition of the costs of public infrastructure investment, the current budgeting rules places infrastructure investment projects at a disadvantage, because those projects would seem expensive relative to other government purchases.

Lumping together current government expenditures and public investment as the federal budget now does makes no sense since public investment is different from current government expenditures in both character and economic consequences. Capital budgets are used by private businesses—as well as by most cities and states—because they help management distinguish between ordinary operating expenses that a company routinely incurs during the course of doing business and extraordinary ones that add to a business's capacity to grow and thus should be depreciated over a number of years. Like most business investment, most public investment, especially most public infrastructure projects, should be paid for over the useful life of the investment. Moreover, the fact that public infrastructure investment earns a return on investment in the form of higher productivity and increased tax revenues should be reflected in how we account for it.

Capital budgeting would allow us to better reflect the true cost of public infrastructure investment in any one given year because it would allow us to depreciate the expense over the useful life of the investment. It would thus eliminate the distortions in the budget that large public infrastructure projects can create and thus reduce the bias against funding them. At the same time, it would create more budgetary discipline because it would force us to do a more thorough evaluation of various government expenditures to determine productive from unproductive projects.

In summary, a federal capital budget would not alone correct the problem of chronic underinvestment in public capital. But it would eliminate the disadvantage public infrastructure now suffers from in the appropriations process. As importantly, it would make possible a more rigorous assessment of our spending priorities and help negate some of the unfounded concerns over the budget deficit that now work against public infrastructure spending.